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Dissension at NFMA

'Harmonization' Plans Spark Debate

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By Andrew Ackerman

MIAMI BEACH, FLA.- A number of analysts are concerned about the possible unintended consequences of rushing to "harmonize" the rating agencies' municipal and global rating scales, and are calling for market participants to meet to discuss the issue with the three major rating agencies.

Though many of the analysts gathered here Friday for the National Federation of Municipal Analysts' annual conference conceded that some changes to the municipal ratings scales are certain to be made eventually, they said that they are deeply troubled by those who want immediate changes. Others said they are opposed to any changes at all.

"While I think that some portions [of the proposals] are inevitable, I think we're going in the wrong direction," Jim Murphy, a portfolio manager at T. Rowe Price, said during a Wednesday panel, drawing about 10 seconds of applause from hundreds of analysts in the audience. No other remarks on the panel drew a similar response.

Officially, the NFMA has not advocated for or against the proposals - floated by California Treasurer Bill Lockyer and Moody's Investors Service - because its members include rating agency analysts and the group has a general policy of not taking a stand on the business polices of its members, said Tom Weyl, the group's immediate past chairman who is vice president and manager of municipal research at Eaton Vance Management in Boston.

Weyl said Friday that the NFMA would like to work with other market participants to hold a conference on the ratings issue, possibly by reconstituting the Muni Council, an organization of about 20 muni market groups that worked to improve disclosure practices earlier in the decade. The Muni Council was responsible for the establishment of the Central Post Office secondary market disclosure site that is operated by the Municipal Advisory Council of Texas.

"Muni Council was a good forum for discussion and feedback," Weyl said. "We're wondering if there isn't a way to bring the parties in the market together in a similar manner."

But the Muni Council has been inactive for a few years and Weyl said it was unclear who would sponsor such a meeting.

Weyl's remarks comes after the NFMA released a position paper earlier this month expressing concern that "recent statements by public officials advocating radical and sudden changes to the municipal rating scale," such as making municipal bond ratings mirror corporate ratings, "could threaten the restoration of a smoothly functioning market."

Though the paper doesn't mention anyone by name, NFMA members last week said it was meant to refer generally to the comment by House Financial Services Committee chairman Barney Frank, D-Mass., who gave the market a deadline for resolving the discrepancy between corporate and municipal ratings.

NFMA members said their paper also comes on the heels of Lockyer's aggressive campaign to lobby the three rating agencies to merge their dual municipal and global rating scales into a single scale that values municipal issuers' default history as essentially the only factor for determining muni ratings.

Historically, issuers have harmonized the differences in their muni ratings with the corporate rating scale through bond insurance, but as the insurers have been downgraded, so have the muni bonds they insured and money market funds have suddenly been unable to purchase or hold the lower-rated munis.

Under the Lockyer proposal, which has received support from several issuers and broker-dealer firms, most municipal bonds would be rated double- or triple-A. Some supporters say there could be gradations or "modifiers" within the new global scale to reflect investor requests to maintain some differentiation among municipal credits.

If the rating agencies choose not to act, Lockyer has called on the Securities and Exchange Commission to amend its Rule 2A-7 on money market funds to take into account the different scales.

Lockyer spokesman Tom Dresslar said Friday: "We understand you can't rush off on these kinds of endeavors willy-nilly." He also seemed to support Weyl's call for a meeting of all market participants.

"All we've asked for is for folks to sit down and engage in a dialogue," Dresslar said.

But he took issue with the NFMA paper's tone, which he said was not "helpful to engaging in a reasoned" debate.

"This is not the work of a rowdy band of malcontents," Dresslar said. "The list of supporters includes organizations that include 17,500 government finance officials and more than 650 securities and market firms," he said. The supporters include the Government Finance Officers Association and the Securities Industry and Financial Markets Association, which have both written to Moody's Investors Service expressing support for that firm's request for comment on its plan to provide an issuer with a global rating, for a fee.

Dresslar added: "We are going to continue to mount an aggressive, public campaign. We're not going to do it behind closed doors. We're fighting for tax-payers. We will speak to them as well as market participants, and in terms they can understand."

The NFMA's paper outlined four major topics for debate, including whether muni issuers should be rated similar to corporate issuers when disclosure requirements are far looser in the muni market.

"The stakes of this debate are extremely high and the NFMA believes that the loudest voices should not be permitted to drown out that have yet to be heard," the group said in its paper.

Weyl said Friday that he is personally conflicted by the proposals to harmonize ratings. Stressing that he was not speaking for NFMA, he said that he saw the proposals as "a“full-employment act"”for analysts. If every municipal security is rated triple- or double-A, analysts will be in greater demand to assess the strength of muni credits. But, he said, he did not intellectually believe any of the arguments that supporters were making for harmonization.

"Even though it's in my economic best interests, I think the arguments are false,"” he said.

For instance, he disputed the notion, floated by some supporters of Lockyer's plan, that investors are confused by the existing rating structure. Weyl said adding a global rating to a municipal bond issue would only increase confusion because some investors would not understand the difference between the two.

Matt Fabian, managing director at Municipal Market Advisors, who spoke at the NFMA conference on Wednesday, agreed that the importance of credit analysts would increase but said that, given the comments made by Frank and other lawmakers, "it just seems difficult to see a world"" that does not move toward harmonization.

Fabian said that if the other three major rating agencies do not begin to add global ratings, new competitors will emerge to provide municipal issuers with ratings based on a global scale. And he disputed Weyl's argument that the addition of a global rating would spawn additional confusion by pointing out that several highly sophisticated investors that he knows do not understand that munis are currently rated on a separate scale from the scale for corporate and structure finance products.

"No amount of education can explain that there are separate scales," he said.

Several critics of the harmonization proposals point to a recent analysis by Richard Ciccarone, managing director and chief research officer at McDonnell Investment Management LLC. The analysis reported that munis were rated more like corporate debt during the Great Depression, but agencies switched to the existing muni scales after hundreds of municipalities went into default on their bonds.

Though supporters of wholesale ratings harmonization point to rating agency default studies that show relatively few defaults since 1970, Ciccarone noted that one should not ignore the wave of defaults that took place during the Depression and "led to the reasons why the current rating differentials came into being."

"The 30-year study model is nowhere near long enough," he said.

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